

VZCZCXYZ0000
RR RUEHWEB

DE RUEHKB #0446/01 1330526
ZNY CCCCC ZZH
R 120526Z MAY 08
FM AMEMBASSY BAKU
TO RUEHC/SECSTATE WASHDC 5289
INFO RUCNCIS/CIS COLLECTIVE
RUEHAK/AMEMBASSY ANKARA 2815
RUEHIT/AMCONSUL ISTANBUL 0121
RUCPDOG/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

C O N F I D E N T I A L BAKU 000446

SIPDIS

E.O. 12958: DECL: 05/13/2018
TAGS: [ECON](#) [EFIN](#) [PREL](#) [PGOV](#) [AJ](#)
SUBJECT: U/S JEFFERY MEETS WITH KEY AZERBAIJANI MINISTERS
AND ENERGY EXECUTIVES

Classified By: AMBASSADOR ANNE E. DERSE PER REASON 1.4 (B, D)

11. (C) SUMMARY: During an April 22 visit to Baku, Under Secretary for Economic, Energy, and Agricultural Affairs and Coordinator for International Energy Affairs Reuben Jeffery III discussed with the Foreign Minister and State Oil Company president the importance of gas transit and securing Caspian regional gas for export to Europe. Private energy companies also spoke to Jeffery about the difficulties of operating in Azerbaijan. The Minister of Finance and Oil Fund Executive Director told U/S Jeffery about Azerbaijan's efforts to modernize Azerbaijan while saving for future generations. END SUMMARY.

FOREIGN MINISTER STRESSES ENERGY COOPERATION

12. (C) Foreign Minister Elmar Mammadyarov stressed that Azerbaijan's successful development of its energy resources was due to strong cooperation with the United States, and sought continued U.S. assistance as Azerbaijan develops new gas resources and export routes to Europe. Mammadyarov commented that Azerbaijan's energy policies had strengthened Azerbaijan's sovereignty, independence, and regional role. He questioned EU support for new Caspian energy projects, adding that Berlusconi's election could put the Turkey-Greece-Italy interconnector in question. However, negotiations with the Turks on gas transit arrangements were moving in a positive direction, as the Turks were reconsidering their position on the 15 percent netback proposal which Azerbaijan opposes.

13. (C) Mammadyarov was positive about Azerbaijan's growing relationship with Turkmenistan. He confirmed that Turkmen President Berdimuhamedov would travel to Baku next month and the GOAJ was hopeful that the visit would result in "good progress" on new Trans-Caspian energy projects. Azerbaijani Deputy Foreign Minister Khalaf Khalafov will travel to Turkmenistan during the week of April 28 for preparatory talks. The GOAJ hopes to press for cooperation on offshore projects, leaving agreement on a median line for Caspian delimitation to "later." He added that Azerbaijani-Turkmen agreement on Caspian delimitation would solve "all problems" with respect to Iran's Caspian claims. Asked what more the U.S. can do to support Azerbaijan-Turkmenistan cooperation, Mammadyarov said nothing for the moment. Mammadyarov promised to brief the U.S. following Berdimuhamedov's visit to Baku, noting that Azerbaijan's fledgling cooperation with Turkmenistan was "very sensitive and fragile," although moving the right direction.

14. (C) Mammadyarov said that development of non-energy sectors was critical for Azerbaijan's long-term prosperity. Azerbaijan is using its estimated USD 70 billion in energy revenue for much-needed infrastructure and regional

development projects. Mammadyarov agreed that improvements in Azerbaijan's business climate were needed to attract foreign investment, and stressed that he wanted more U.S. companies to work in Azerbaijan. Mammadyarov also agreed to look into U.S. company Cargill's long-standing commercial dispute (and subsequently instructed his aide to follow-up). He commented that U.S. company Bechtel's trans-national highway proposal was "extremely expensive," adding that Korean companies were prepared to build roads at half the price. However, the Bechtel project is "still under consideration."

MINISTER OF FINANCE

15. (C) Finance Minister Sharifov provided an overview of Azerbaijan's macroeconomic conditions, noting that increased global commodity prices were affecting consumer prices in Azerbaijani. Sharifov said that Azerbaijan's National Bank was going to change its exchange rate policy and peg the Azerbaijani manat to a basket of currencies from its primary trading partners. Sharifov hoped that this adjustment would allow the manat to appreciate slowly and dampen inflationary pressures. Sharifov also hinted that the GOAJ would trim expenditures in order to keep overall prices down, although he argued that Azerbaijan was using its capital expenditures (approximately USD 4.6 billion in 2008) to modernize and build critical infrastructure. Sharifov also noted that the GOAJ is working on a supplemental 2008 budget and that the 2009 budget expenditures will total approximately USD 13 billion. Sharifov said that Azerbaijani commercial banks were borrowing from international markets and argued that it was important to match monetary supply with increased demand, noting that "internal problems" (monopolies) dampened demand. Sharifov recognized that inflation is a tax on the poor and reiterated that the GOAJ is working to combat rising prices.

16. (C) Sharifov said that the GOAJ is keen to continue the economic dialogue, noting that the Economic Partnership Commission (EPC) is a valuable forum and that Azerbaijan is looking to expand its economic cooperation with the U.S. Sharifov explained the reasons for postponing the EPC, noting time constraints and the supplemental budget deliberations. Sharifov said that the EPC should be re-scheduled for a convenient time in June. He said that the GOAJ wanted to add new agenda items, such as repeal of the Jackson-Vanik amendment, in order to make the dialogue a "two-way street." Sharifov told U/S Jeffery about the government's plans to fund, through the Oil Fund, Azerbaijani students' studies abroad. He said that GOAJ had formed an education commission, chaired by Presidential Chief of Staff Ramiz Mehdiyev, to review selection guidelines and procedures.

STATE OIL FUND

17. (C) State Oil Fund (SOFAZ) Executive Director Shahmar Movsumov briefed U/S Jeffery on SOFAZ's mission, operations and future plans. Movsumov said that SOFAZ currently had USD 3.5 billion in assets, adding that in 2008 SOFAZ would receive approximately USD 12 billion and in 2009 USD 15-17 billion in energy revenues. Movsumov stated that in May 2008 SOFAZ expected to receive USD 1.5 billion in revenue inflows, its largest monthly inflow ever. In the next five years, SOFAZ expects to receive between USD 100-120 billion in revenues. Movsumov told U/S Jeffery that 97 percent of SOFAZ's revenues comes Azerbaijan's share from the sale of Azeri-Chirag-Guneshli profit oil. He explained that the ACG operator, BP, sells the oil on behalf of the Azerbaijani State Oil Company and the proceeds are transferred to SOFAZ.

18. (C) Movsumov said that the fund's assets were invested in 50 percent U.S. dollar denominated assets and 50 percent in non-U.S. assets, including Euros, Sterling pounds and other sovereign and corporate debt issuances. Movsumov said that SOFAZ would begin investing in equities in 2009, adding that SOFAZ would need to use external asset managers for its

equity investments. Currently, SOFAZ manages 95 percent of its portfolio internally, and uses three international money managers to invest the remaining 5 percent of SOFAZ assets. Movsumov noted that SOFAZ has its own research and analysis team for its fixed income investments.

¶9. (C) In order to prepare itself for these massive energy revenue inflows, Movsumov stated that SOFAZ had been working to improve its personnel's knowledge and skill capabilities through various trainings. In addition, SOFAZ noted that the U.S. Trade Development Agency had also been providing on-going technical assistance through a series of grants which had resulted in a stronger institution. Movsumov briefed U/S Jeffery on SOFAZ-funded national projects, including several water infrastructure projects and the Government of Azerbaijan's plans to fund studies abroad for Azerbaijani students.

¶10. (C) Noting its transparency and number of annual and quarterly reports, Movsumov told U/S Jeffery that Azerbaijan was a leading country in the Extractive Industries Transparency Initiative. Movsumov said that Azerbaijan was the first country to prepare full EITI reports. Turning to the current debate on sovereign wealth funds, Movsumov said that Azerbaijan wanted to contribute to the current discussion and that SOFAZ would always invest based on return and not political agendas. Movsumov cautioned that expanding the EITI-concept to other parts of the supply chain, an idea proposed by the World Bank, could dilute the impact of EITI and have potential negative results.

SOCAR

¶11. (C) In a meeting that was severely truncated due to an earlier-than-expected meeting with President Aliyev (septel), SOCAR President Abdullayev said the recent gas sales agreement with Georgia would supply enough GOAJ gas for Georgian demand for this year and the next. On Shah Deniz Phase Two (SD2) gas sales, SOCAR was negotiating with the various commercial entities involved with the major pipeline projects (TGI, TAP, Nabucco). The two major issues in the way of SD2 gas sales to Europe were agreement with Turkey on terms for transit of Azerbaijani gas and the EU's gas marketing restrictions. Abdullayev said that "SOCAR was ready" for gas sales; it was Europe and the EU that were dragging their feet. For example, SOCAR had told the Nabucco consortium in 2006 that it was ready to sell it 4 billion cubic meters annually, and SOCAR Vice-President Elshad Nasirov was negotiating with the EU so that Azerbaijan could sell directly to Europe. On Azerbaijani energy sector development, Abdullayev said that Azerbaijan had two trillion cubic meters of proven gas reserves and additional unproven reserves. SOCAR had a "major gas program" to develop these resources, to include exploratory drilling at the "Umid" offshore field starting before the end of 2008.

DINNER WITH ENERGY EXECUTIVES

¶12. (C) Executives from BP, Hess, Chevron, and ExxonMobil discussed the difficult business environment, Azerbaijan's relationship with its neighbors, and the importance of ensuring security for energy transportation. Chevron's Country Manager said the GOAJ's attempts to squeeze more money out of the larger energy companies despite previously agreed to PSAs, is problematic and sets a bad example for other companies looking to do business in Azerbaijan. Corruption and the conflict of interest of many high-ranking GOAJ officials make it even more difficult for smaller companies or sub-contractors working for the Azerbaijan International Oil Company (AIOC) operators. The executives contrasted the high level of corruption in Azerbaijan with Georgia, where they said corruption is lessening. While the executives agreed that the lack of institutional capacity means that some orders from top GOAJ officials are not always correctly carried out at the working level, they cited examples like SOCAR's newly purchased company plane as an

example of how high-ranking GOAJ officials set a bad example for spending and corporate governance. COMMENT: SOCAR justifies the plane, according to SOCAR VP Nasirov, as supporting Azerbaijan's intensified energy diplomacy in Europe and the Caspian.

¶13. (C) The executives noted that Azerbaijan faces a complex regional position. So far, they said, Azerbaijan has been willing and able to resist Russia's energy pressure, but has not gone so far as to build strong mutual ties with other neighbors. Although the GOAJ was disappointed by a perceived lack of gratitude for its decision to supply Georgia with gas, one executive noted that the GOAJ had been willing to help because it could pass the cost along to the companies operating in Azerbaijan. The executives argued that Azerbaijan could learn an important lesson about ensuring that democratic institutions are strengthened to prevent society from turning to the institution it does have -- religion. One executive noted that despite Iran's thin veneer of piousness and anti-American sentiment, many people are not deeply religious and harbor no personal ill will towards America and the West where many now have family members living. ExxonMobil's Country Manager pointed out that there is little cooperation between Kazakhstan and Azerbaijan despite the fact that both could benefit from working together.

COMMENT

¶14. (C) U/S Jeffery's visit to Baku underscored the USG's commitment to working with Azerbaijan as an economic and energy partner. The GOAJ is moving in the right direction on many fronts, especially in regard to its energy policy, its relationship with Turkmenistan and transit discussions with Turkey. Azerbaijan needs to do more, however, to promote the broader economic reforms -- particularly in the non-energy sector -- necessary to ensure its long-term, sustainable development. Finally, Minister Sharifov's commitment to the EPC is positive, but while GOAJ officials regularly say the right things, concrete steps are needed to improve the business climate.

¶15. (U) U/S Jeffery cleared this cable.
DERSE